

NOTE: This handout is intended only for purposes of facilitating discussion at the September 8, 2017 interested parties meeting.

## Explanation and Background for Proposed Adoption of Regulation 18662-7

California Revenue and Taxation Code (RTC) section 18662 provides the law setting forth the general withholding requirement scheme for nonresident and real estate withholding. The corresponding regulations at California Code of Regulations, title 18, (CCR) sections 18662-0 through 18662-6 and 18662-8 (Withholding Regulations) detail more specific guidelines with respect to California's nonresident and real estate withholding procedures. On April 13, 2017 the Franchise Tax Board (FTB) approved staff's request to proceed with the formal regulatory process to update these Withholding Regulations.

The FTB previously held an Interested Parties Meeting (IPM) on December 12, 2014 for the public to provide input on a proposed addition to the Withholding Regulations to address issues arising with domestic pass-through entity withholding. The proposed adoption of a new regulation at CCR section 18662-7 (Proposed Regulation) would address these issues. A summary of the first IPM for the Proposed Regulation was made available to the public and can be accessed [here](#). The Proposed Regulation references to CCR sections 18662-0 through 18662-6 and 18662-8 reflect the FTB's anticipated updates to the Withholding Regulations.

For the second scheduled IPM for the Proposed Regulation, additional documents are being made available, identified as follows: the second IPM announcement, the Proposed Regulation draft language, diagrams to illustrate the examples of the Proposed Regulation text, and this document, which provides a background and more explanation on the proposed regulatory language. The first three documents can be found on the department's Interested Parties Meeting page, [here](#), and Regulatory Activity page, [here](#).

Accordingly, the text of the Proposed Regulation is set forth immediately below in underlined format, with explanations describing the reasoning for each suggested addition following each subsection of the text:

Regulation 18662-7 is adopted to read:

### 18662-7. Domestic Pass-Through Entity Withholding.

- (a) General. A pass-through entity is required to withhold tax on behalf of a nonresident owner in an amount equal to the nonresident owner's tax rate of withholding multiplied by the nonresident owner's distributive share of the pass-through entity's California source income.

The most important changes made to pass-through entity withholding are found in this Proposed Regulation section. Pass-through entities will be required to withhold on behalf of a nonresident owner's distributive share of the pass-through entity's California source income

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rather than withhold on distributions paid. The withholding rate for pass-through entity withholding also will be increased from 7% to the highest marginal tax rate.

The language in this Proposed Regulation section is similar to the language that a majority of the other states use, including distributive share language and the application of the highest marginal tax rate. RTC section 18662 authorizes the FTB to require any person who has the control, receipt, custody, disposal, or payment of items of income, to withhold an amount determined by the FTB to reasonably represent the amount of tax due when the items of income are included with other income of the taxpayer, and to transmit the amount withheld to the FTB at the time it may designate. "Items of income" are then listed and include "partnership income or gains." Therefore, requiring withholding on the nonresident owner's "distributive share" of income is consistent with this language because the distributive share is the partner's share of "partnership income or gains."

(b) Definitions.

- (1) Distributive Share of Income. For purposes of this subsection, distributive share of income shall be computed under Chapters 9 through 11 of Part 10 of the Revenue and Taxation Code; and Chapters 4.5 and 17 of Part 11 of the Revenue and Taxation Code.

California generally conforms to the IRS definition of distributive share. California-specific modifications are found in the RTC. Chapter 9 of Part 10 of the RTC provides certain modifications that may be applicable for the computation of the distributive share of income for beneficiaries of an estate or trust. Chapter 10 through 11 of Part 10 of the RTC provides certain modifications that may be applicable for the computation of the distributive share of income for partners of a partnership. Chapter 4.5 of Part 11 of the RTC provides certain modifications that may be applicable for the computation of the distributive share of income for shareholders of an S corporation. Chapter 11 of Part 10 of the RTC and Chapter 17 of Part 11 of the RTC apply for apportioning and allocating the nonresident owner's distributive share of the pass-through entity's California source income.

- (2) Income from California Sources Subject to Withholding. The amount subject to withholding by a pass-through entity is calculated based upon the pass-through entity's California source income. A nonresident owner's distributive share of a pass-through entity's California source income is determined in the manner described in Regulation section 25137-1 for nonresident corporate partners and Regulation section 17951-4 for all other nonresident owners.

RTC section 17951 requires individual nonresidents of California to be taxed on all income from California sources. In contrast, California resident individuals are taxed on worldwide income. Because withholding requires income tax to be withheld on behalf of nonresident owners, the

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amount subject to withholding is limited by the nonresident owner's distributive share of the pass-through entity's California source income.

The nonresident owner's distributive share of the pass-through entity's California source income is determined pursuant to CCR section 25137-1 and CCR section 17951-4. CCR section 25137-1 provides the apportionment and allocation rules for non-California corporate partners and CCR section 17951-4 provides the apportionment and allocation rules for other nonresident owners.

If a nonresident owner of an interest in the pass-through entity that is not a corporate partner and carries on a unitary business with the pass-through entity within and without the state, then the nonresident owner's distributive share of income is calculated pursuant to CCR section 17951-4(d). Similarly, if a nonresident owner of an interest in the pass-through entity is a corporate partner and carries on a unitary business with the pass-through entity within and without the state, then the owner's distributive share of income is calculated pursuant to CCR section 25137-1(f). Pursuant to both CCR sections, the combined unitary business income is apportioned pursuant to RTC sections 25120-25139, and in accordance with the apportionment rules of the Uniform Division of Income for Tax Purposes Act (UDITPA).

- (3) Lower Tier Pass-Through Entity. A lower tier pass-through entity is a pass-through entity with California source income that has an owner that is a pass-through entity.

The definition of a lower tier pass-through entity was adapted from the federal definition of a lower tier partnership in Treasury Regulation section 1.1446-5, for tiered partnership structures subject to foreign partnership withholding. The essential requirement to be treated as a lower tier pass-through entity is for a pass-through entity to have an owner that is also a pass-through entity.

- (4) Nonresident Owner. A nonresident owner includes partners, members, and shareholders that are nonresidents of California, in addition to beneficiaries of an estate or trust that are nonresidents of California. A nonresident owner includes owners that are nonresident individuals and owners that are non-California business entities, including, but not limited to, such entities as pass-through entities, publicly traded partnerships, master limited partnerships, estates or trusts, corporations, and suspended or forfeited corporations.

- (A) Nonresident Individual. A nonresident individual is as defined in Regulation section 18662-2(j) and Regulation section 18662-4.

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(B) Non-California Business Entity. A non-California business entity is as defined in Regulation section 18662-2(i) and includes non-California business entities that are doing business in California within the meaning of Revenue and Taxation Code section 23101 and receiving California source income, as explained in Regulation section 18662-4(b)(2).

The definition of nonresident owner is intentionally broad and includes individuals, corporations, and all other non-California business entities, as defined in CCR section 18662-2(i). Non-California business entities include pass-through entities as well as publicly traded partnerships, master limited partnerships, and corporations, as well as nonresident estates and trusts, suspended and forfeited corporations, and foreign (non-U.S.) corporations, as explained in CCR section 18662-4(a)(1). The authority to require withholding on behalf of these entities and individuals comes from the Constitutional power to tax California source income over which the California pass-through entity withholding agent has control and custody.

Nonresident individual and non-California business entity definitions were separated out to further identify and direct where the definitions can be found within the applicable Withholding Regulations.

(5) Pass-Through Entity. For purposes of this regulation, a pass-through entity includes a partnership (as defined by Revenue and Taxation Code section 17008 and Regulation section 18662-2(o)), estate or trust, and S corporation.

A pass-through entity is generally an entity that passes its income or losses through to its owners instead of paying the related tax at the entity level (notwithstanding California modifications that impose an entity-level tax on S corporations and certain annual taxes and fees on certain partnerships and limited liability companies). The owners of a pass-through entity must then include the income or losses on their own tax returns. Types of pass-through entities for purposes of this regulation include estates and trusts, S corporations, and partnerships. Partnerships include general partnerships, limited partnerships, limited liability partnerships, as well as entities such as limited liability companies (LLCs) that are taxed as partnerships. "Partnerships" within the pass-through entity definition includes a citation to RTC section 17008 and CCR section 18662-2(o) to include the list of multiple entities.

(6) Pass-Through Entity Owner. A pass-through entity owner includes partners, members, or S corporation shareholders that own an interest in a pass-through entity, and beneficiaries of an estate or trust. A pass-through entity owner includes individuals and non-California business entities, including, but not limited to, such entities as pass-through entities, publicly traded partnerships, master limited partnerships, estates or trusts, corporations, and suspended or forfeited corporations.

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The pass-through entity owner definition is modeled after the nonresident owner definition found in Proposed Regulation subsection (b)(4), without the requirement that the owner be a nonresident of California.

The purpose behind this definition is to define "pass-through entity owner" for upper tier pass-through entity owners that have been allocated withholding paid on behalf of the upper tier owner by its lower tier pass-through entity. When this occurs, the upper tier pass-through entity must allocate withholding paid on its behalf to its owners, regardless of California residency. As a result, upper tier pass-through entity owners, regardless of California residency, are allocated withholding and may claim the withholding credit on their income or franchise tax return if they are not a pass-through entity. If they are a pass-through entity, they may be required to further allocate the withholding.

(7) Tax Rate of Withholding. The pass-through entity shall withhold at the rate specified below with respect to each nonresident owner.

- (A) Nonresident Individual Owner. The tax rate applicable to each nonresident individual owner's distributive share shall consist of the highest marginal tax rate or rates in effect under Revenue and Taxation Code section 17041.
- (B) Pass-Through Entity Nonresident Owner That is a Non-California Business Entity. The tax rate applicable to the distributive share of each nonresident owner that is itself a non-California business entity owner of the pass-through entity shall be the following:
  - (i) Pass-Through Entity Owner That is a Corporation. The tax rate applicable to the distributive share of each nonresident owner that is itself a non-California corporate owner of the pass-through entity shall consist of the tax rate in effect under Revenue and Taxation Code section 23151(f)(2); or, if applicable, the tax rate in effect under Revenue and Taxation Code section 23186.
  - (ii) Pass-Through Entity Owner That is an S Corporation. The tax rate applicable to the distributive share of each nonresident owner that is itself a non-California S corporation owner of the pass-through entity shall consist of the tax rate in effect under Revenue and Taxation Code section 23802. The tax rate applicable to the distributive share of each resident or nonresident owner of a non-California upper tier S corporation

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shall consist of the highest marginal tax rate in effect under Revenue and Taxation Code section 17041.

- (iii) Pass-Through Entity Owner That is an Upper Tier Pass-Through Entity Other Than an S Corporation. The tax rate applicable to the distributive share of each nonresident owner that is itself a non-California upper tier pass-through entity shall consist of the highest marginal tax rate in effect under Revenue and Taxation Code section 17041.

A majority of the other states that have mandatory pass-through entity withholding require the pass-through entity to withhold at the highest marginal tax rate. Proposed Regulation subsection (b)(7)(A) is modeled after RTC section 18535, which applies the highest marginal tax rate for group returns for nonresident partners, shareholders and members, including amounts treated as if imposed under section 17041, and including the 1% mental health tax rate, as well as the additional tax rates imposed by Proposition 30.

If the nonresident owner is an individual, then the highest marginal tax rate is the tax rate applied for individuals under RTC section 17041, including the 1% mental health tax rate, as well as the additional tax rates imposed by Proposition 30.

If the nonresident owner is a corporation, then the highest marginal tax rate is the tax rate applied for corporations under RTC section 23151, or RTC section 23186, if applicable. RTC section 23186 is applicable if the corporation is a bank or financial corporation.

If the nonresident owner is an S corporation, then the highest marginal tax rate is the tax rate applied for S corporations under RTC section 23802. Additionally, if the nonresident owner is an S corporation, then the lower tier pass-through entity must withhold tax on the distributive share of the S corporation owner at the highest marginal tax rate under RTC section 17041. The reasoning behind this is to be consistent with the S corporation tax treatment under RTC sections 23802 and 23802.5.

If the nonresident owner is an upper tier pass-through entity, then the highest marginal tax rate is the highest marginal tax rate under RTC section 17041. Massachusetts has pass-through entity withholding similar to California, and currently applies the highest marginal tax rate for individuals to upper tier pass-through entities where tax is being withheld.

- (8) Upper Tier Pass-Through Entity. An upper tier pass-through entity is an owner of a pass-through entity that is itself a pass-through entity. An upper tier pass-through entity also includes any owner of an upper tier pass-through entity that is itself a pass-through entity.

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The definition of an upper tier pass-through entity was adapted from the IRC definition of an upper tier partnership in Treasury Regulation Section 1.1446-5, for tiered partnership structures for foreign partnership withholding.

The definition of upper tier pass-through entity includes all upper tier pass-through entities in a tiered pass-through entity structure. As a result, any owner of an upper tier pass-through entity that is also a pass-through entity is considered an upper tier pass-through entity and must follow the applicable withholding requirements for such an entity.

- (c) Withholding Payment Due Dates. Payment of withholding on distributive share of income is due by the federal estimated due date as required by Regulation section 18662-8(c)(1)(B). An upper tier pass-through entity that is only allocating withholding paid on its behalf is not required to remit withholding under this subsection unless it has a separate withholding requirement under subsection (f).

This Proposed Regulation subsection reflects the FTB's anticipated updates to the Withholding Regulations at CCR section 18662-8(c)(1)(B), requiring withholding payments by the federal estimated due dates. This is important to ensure pass-through entity withholding agents are aware that, although Form 592-PTE will be due on an annual basis rather than by the federal estimated due dates, withholding payments will continue to be due by the federal estimated due dates.

An upper tier pass-through entity that is only allocating withholding paid on its behalf is not required to remit withholding because it has already been paid. This does not eliminate the upper tier pass-through entity's separate withholding requirement under Proposed Regulation subsection (f).

- (d) Reporting Requirements.

- (1) Reporting to Franchise Tax Board.

- (A) Form 592-Q, Payment Voucher for Pass-Through Entity Withholding. A pass-through entity must submit a Form 592-Q with each withholding remittance in accordance with Regulation sections 18662-0 through 18662-8. An upper tier pass-through entity that is only allocating withholding paid on its behalf is not required to file Form 592-Q unless it has a separate withholding requirement under subsection (f). See Regulation section 18662-8, subsection (l).

Form 592-Q is similar to Form 592-V and Form 592-A, as it is a payment voucher. The only difference is that it is a voucher for pass-through entities that are remitting withholding.

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Because it is a voucher that is sent with the withholding remittance, an upper tier pass-through entity that is only allocating withholding paid on its behalf is not required to file a Form 592-Q.

- (B) Form 592-PTE, Pass-Through Entity Annual Withholding Return. A pass-through entity that has withheld on the income of a nonresident owner or has had its income withheld upon is required to file a Form 592-PTE on an annual basis to allocate withholding in accordance with Regulation sections 18662-4 and 18662-8. See Regulation section 18662-4, subsection (j).
- (i) Lower Tier Pass-Through Entity. A lower tier pass-through entity that has withheld on income of nonresident owners is required to file a Form 592-PTE to allocate withholding to each nonresident owner that has income that has been withheld upon, in accordance with each nonresident owner's interest in the lower tier pass-through entity.
  - (ii) Upper Tier Pass-Through Entity. An upper tier pass-through entity that has income that has been withheld upon by a lower tier pass-through entity is required to file a Form 592-PTE to allocate withholding paid on its behalf to each owner, whether a resident or nonresident of California, in accordance with each owner's interest in the upper tier pass-through entity.
    - (I) Upper Tier Pass-Through Entity Owner. Any owner of an upper tier pass-through entity that is itself a pass-through entity must likewise file a Form 592-PTE to allocate withholding to each owner, whether a resident or nonresident of California.
    - (II) Allocation of Withholding Paid. Once Form 592-PTE allocates withholding paid to an upper tier pass-through entity, the withholding payment made by the lower tier pass-through entity is treated as having been paid on behalf of each upper tier pass-through entity owner.
    - (III) Credit for Tax Withheld. If an upper tier pass-through entity claims any of the amount withheld on its tax return for the entity-level tax imposed, it must attach a schedule to Form 592-PTE specifying the amount claimed on the upper tier pass-through entity's income tax return and amount to be allocated to the upper tier pass-through

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entity's owners. See subsection (e)(2) and Regulation section 19002, subsection (b).

A withholding agent that has paid withholding on behalf of nonresident owners must allocate that withholding to the nonresident owners to allow the nonresident owners to claim the withholding credit on their respective income tax or franchise tax returns. With the anticipated updates to the Withholding Regulations, the withholding credit will be allocated to the nonresident owners by filing Form 592-PTE with FTB on an annual basis.

Without the anticipated updates to the Withholding Regulations, the withholding credit is allocated to nonresident owners by filing Form 592 by the federal estimated due dates, rather than on an annual basis. Upper tier pass-through entities that have income that has been withheld upon are sometimes unable to timely file their Form 592 by the federal estimated due dates because withholding information is not received from the lower tier pass-through entity until after the Form 592 federal estimated due dates. If the upper tier pass-through entity fails to timely file its Form 592, then the withholding credit may not be properly allocated in time for its owners to claim such withholding credits on their income or franchise tax returns. The upper tier pass-through entity owners may then be denied the withholding credit. In addition, penalties may be imposed on the upper tier pass-through entity for failure to timely file the Form 592.

As a result, the anticipated updates to the Withholding Regulations will require a Form 592-PTE to be due once a year on an annual basis. This will allow an upper tier pass-through entity time to receive withholding information from the lower tier pass-through entity in order to timely file its Form 592-PTE to properly allocate withholding.

Under the anticipated updates to the Withholding Regulations, Form 592-PTE will allocate withholding from the pass-through entity to the respective owners. Proposed Regulation subsection (d)(1)(B) requires both the upper tier pass-through entity and the lower tier pass-through entity to file Form 592-PTE in order to allocate withholding to their respective owners. Specifically, Proposed Regulation subsections (d)(1)(B)(i) and (d)(1)(B)(ii) provide that a lower tier pass-through entity is required to file Form 592-PTE to allocate withholding to its nonresident owners in accordance with their interest in the pass-through entity, while an upper tier pass-through entity that has already been withheld upon is required to file a Form 592-PTE to allocate withholding to its owners, regardless of what state each owner is a resident of, in accordance with their interest in the pass-through entity. All upper tier pass-through entities are required to file Form 592-PTE under the Proposed Regulation to allocate withholding on behalf of all owners, regardless of the owners' residency, in accordance with their interest in the entity. As a result, under the Proposed Regulation, if an owner of an upper tier pass-through entity is also a pass-through entity, then it is an upper tier pass-through entity and must also file a Form 592-PTE to allocate withholding to its owners, regardless of what state each owner is a resident of, in accordance with their interest in the pass-through entity.

(2) Notification to Owners of Withholding.

(A) Form 592-B, Resident and Nonresident Withholding Tax Statement. A pass-through entity that has withheld on income of a nonresident owner or has income that has been withheld upon is required to provide a Form 592-B to each owner that is allocated withholding in accordance with Regulation sections 18662-0 through 18662-8. See Regulation section 18662-8, subsection (m).

(i) Lower Tier Pass-Through Entity. A lower tier pass-through entity that has withheld on income of nonresident owners is required to provide a Form 592-B to each nonresident owner that has income that has been withheld upon.

(ii) Upper Tier Pass-Through Entity. An upper tier pass-through entity that has income that has been withheld upon by a lower tier pass-through entity is required to provide a Form 592-B to each owner, whether a resident or nonresident of California, that is to be allocated withholding. Any owner of an upper tier pass-through entity that is itself a pass-through entity must likewise provide a Form 592-B to each owner, whether a resident or nonresident of California, that is to be allocated withholding.

The filing requirements for pass-through entities filing Form 592-B are already in CCR 18662-8(c)(3)(B) and are the same for pass-through entities as for all withholding agents. The 10-day notification requirement has no impact on the Form 592-B filing requirements.

Lower tier pass-through entities and upper tier pass-through entities are required to send a Form 592-B to all owners that are to be allocated withholding paid. Lower tier pass-through entities are required to send Form 592-B to all nonresident owners who are allocated the withholding that has been paid on their behalf. Upper tier pass-through entities are required to send Form 592-B to all owners, regardless of the owner's state of residency, who are allocated the withholding that has been paid by the lower tier pass-through entity.

(B) 10-Day Notification Requirement. A pass-through entity must notify each nonresident owner of the withholding paid on the nonresident owner's behalf when the pass-through entity remits a withholding payment to the Franchise Tax Board. The notice required to be given must be provided within 10 days of the withholding payment due date, or, if paid later, the date such payment is made. No particular

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form is required for a pass-through entity's notification to a nonresident owner, but each notification must include the pass-through entity's name, identification number, address, and the owner's name, identification number, address, the owner's distributive share of income, and the amount of tax paid on behalf of the owner for both the current pass-through entity's taxable year.

- (C) 10-Day Notification Exception. A pass-through entity is not required to notify a nonresident owner of a withholding payment made on the owner's behalf, unless requested by the owner, if –
- (i) The pass-through entity's agent responsible for providing notice pursuant to this paragraph is the same person that acts as an agent of the owner for purposes of filing the owner's California income tax return for the owner's taxable year that included the withholding payment date; or
  - (ii) The pass-through entity has at least 500 nonresident owners and the total withholding the pass-through entity determines it is required to pay for the tax year on behalf of such owner's distributive share of income is less than \$1,000; or
  - (iii) The pass-through entity is an upper tier pass-through entity that is only allocating withholding paid on its behalf.

This Proposed Regulation subsection is adapted from Treasury Regulation section 1.1446-3(d)(1)(i).

Without the anticipated updates to the Withholding Regulations, the withholding credit is allocated to nonresident owners by filing Form 592 by the federal estimated due dates, rather than on an annual basis. Upper tier pass-through entities that have income that has been withheld upon are sometimes unable to timely file their Form 592 by the federal estimated due dates because withholding information is not received from the lower tier pass-through entity until after the Form 592 federal estimated due dates.

As a result, the anticipated updates to the Withholding Regulations will require a Form 592-PTE to be due once a year on an annual basis. This will allow an upper tier pass-through entity time to receive withholding information from the lower tier pass-through entity in order to timely file its Form 592-PTE to properly allocate withholding.

This Proposed Regulation subsection (d)(2)(B) imposes a 10-day notification requirement to ensure the upper tier pass-through entity receives withholding information from its lower tier

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pass-through entity immediately after withholding payments are paid on its behalf. This allows upper tier pass-through entities more time to receive withholding information from the lower tier pass-through entity to timely file Form 592-PTE, and therefore ensures the withholding credit will be timely allocated when the ultimate owners file their income or franchise tax returns to claim the withholding credit.

(e) Credit for Tax Withheld.

(1) Individuals and Corporations. An individual or corporation, not including an S corporation, that has income that has been withheld upon may claim a refund for withholding paid on the respective individual or corporate franchise or income tax return. To receive a credit for withholding paid, a copy of Form 592-B received from the pass-through entity must be attached to the individual or corporate or income tax return.

(2) Upper Tier Pass-Through Entities. An upper tier pass-through entity that has income that has been withheld upon may not claim a refund for withholding paid on the upper tier pass-through entity's income tax return. The owners of the upper tier pass-through entity may authorize the pass-through entity to use some or all of the withholding credit to satisfy the entity-level tax of the pass-through entity due for the taxable year. See Regulation section 19002, subsection (b). If the upper tier pass-through entity claims any of the amount withheld on its income tax return, then the upper tier pass-through entity must:

(A) Attach a copy of Form 592-B received from the lower tier pass-through entity to the income tax return as well as a schedule specifying the amount to be claimed on the upper tier pass-through entity's income tax return and amount allocated to the upper tier pass-through entity's owners; and

(B) Attach a schedule to Form 592-PTE specifying the amount claimed on the upper tier pass-through entity's income tax return and amount to be allocated to the upper tier pass-through entity's owners.

FTB recently promulgated CCR section 19002(b), which states that no pass-through entity can claim the withholding credit. Instead, a pass-through entity must allocate the withholding credit to its owners. This Proposed Regulation subsection was added because CCR section 19002(b) is specific to pass-through entity withholding and was an issue raised by interested parties.

(f) Separate Withholding Requirement for Upper Tier Pass-Through Entities. If an upper tier pass-through entity that has income that has been withheld upon has California source income, other than income that has already been withheld upon by a lower tier pass-

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through entity, then it may have a separate withholding requirement with respect to such income and may be required to withhold on behalf of each nonresident owner in accordance with Regulation sections 18662-0 through 18662-8.

The purpose behind this Proposed Regulation section is to clarify that the upper tier pass-through entity may not be required to withhold if its only California source income is from a lower tier pass-through entity that has already withheld on such income. However, the upper tier pass-through entity may still have its own, separate withholding requirement.

Throughout these Proposed Regulations, upper tier pass-through entities that are only allocating withholding are identified as having separate rules. The purpose behind this identification is to distinguish upper tier pass-through entities that are only allocating withholding from upper tier pass-through entities that, in addition to allocating withholding, also have a separate withholding requirement.

(g) Penalties. Any pass-through entity required to withhold or report withholding that fails to meet its withholding obligation shall be subject to all applicable penalties under Regulation section 18662-8(d), and Revenue and Taxation Code sections 18668 and 19183.

Pass-through entities that are required to withhold or allocate withholding, i.e., lower tier and upper tier pass-through entities, are all required to meet their withholding obligations, and failure to do so may lead to the imposition of penalties under the Withholding Regulations.

(h) Examples.

Example 1: Upper Tier Pass-Through Entity and Lower Tier Pass-Through Entity Definition.

A is a California general partnership with two equal partners, B and C. B is an individual who is a resident of California. C is a non-California general partnership. C has two equal partners, D and E. D is an individual who is a nonresident of California and E is a California general partnership.

A is a lower tier pass-through entity because it has California source income and it has an owner that is a pass-through entity. C is an upper tier pass-through entity because it is an owner of a pass-through entity, A, and is itself a pass-through entity. E is also an upper tier pass-through entity because it is an owner of a pass-through entity, C, and is itself a pass-through entity.

The purpose behind Example 1 is to set the stage for the main facts of a basic tiered pass-through entity structure and to show where an upper tier pass-through entity and lower tier pass-through entity fall within such a structure.

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### Example 2: Payment Due Date.

Same facts as Example 1. A has \$100,000 of California source income in Year X and remits withholding on behalf of C's \$50,000 distributive share of A's \$100,000 of California source income by the applicable federal estimated tax due date because C is a nonresident owner. A is not required to withhold on behalf of B's \$50,000 distributive share of A's \$100,000 of California source income because B is a resident of California.

Assuming C does not have any California source income other than its distributive share from A, C is not required to remit withholding on behalf of D or E with respect to its \$50,000 distributive share of A's \$100,000 of California source income by the applicable federal estimated tax due date because withholding has already been paid on that income on its behalf by A. Similarly, E is also not required to remit withholding on behalf of its owners with respect to its \$25,000 distributive share of C's \$50,000 of California source income by the federal estimated tax due dates because withholding has already been remitted on that income on its behalf.

The purpose behind Example 2 is to show that lower tier pass-through entities have the burden of remitting withholding by the applicable federal estimated tax due date, and that upper tier pass-through entities who are only allocating withholding already paid on their behalf are not required to remit withholding. Example 2 also shows that withholding payments are only to be made on behalf of nonresident owners, not resident owners.

### Example 3: Form 592-PTE Filing Requirements.

Same facts as Example 2. A is required to file an annual Form 592-PTE following the end of Year X to report the withholding it paid on behalf of C. The filing of Form 592-PTE will allocate the withholding A paid on behalf of C to C. A is not required to file an annual Form 592-PTE following the end of Year X with respect to B because B was a resident of California and no withholding was required to be paid on his or her behalf.

C is required to file an annual Form 592-PTE following the end of Year X to report the withholding A paid on its behalf throughout Year X and that A allocated to C. The filing of Form 592-PTE will allocate the withholding A paid on C's behalf to C's owners, D and E, regardless of the owner's state of residency and in accordance with each owner's interest in C.

D is not required to file an annual Form 592-PTE following the end of Year X with respect to the withholding allocated to him or her because D is an individual and therefore is not required to allocate withholding. D can claim the withholding credit allocated to him or her on the individual California nonresident income tax return if he or she attaches a copy of Form 592-B received from C.

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E is required to file an annual Form 592-PTE following the end of Year X to report the withholding A paid on behalf of C during Year X and that C allocated to E. The filing of Form 592-PTE will allocate the withholding A paid and that C allocated to E and E allocated to E's owners, regardless of the owners' state of residency, and in accordance with each owner's interest in E.

The purpose behind Example 3 is to show the differences in Form 592-PTE filing requirements for lower tier pass-through entities compared with upper tier pass-through entities under Proposed Regulation subsection (d)(1)(B), which incorporates the anticipated updates to the Withholding Regulations requiring the annual filing of Form 592-PTE. Specifically, under Proposed Regulation subsection (d)(1)(B), lower tier pass-through entities are required to file a Form 592-PTE to allocate withholding paid on behalf of nonresident owners, while upper tier pass-through entities are required to file a Form 592-PTE to allocate withholding paid on their behalf to all owners, regardless of the state of residency of each owner.

Another purpose behind Example 3 is to show that all lower tier pass-through entities and all upper tier pass-through entities that have paid withholding or have income that has been withheld upon are required to file an annual Form 592-PTE to allocate withholding.

#### Example 4: Form 592-B Requirements.

Same facts as Example 2. A is required to send a Form 592-B following the end of Year X to C to notify C of withholding paid on its behalf throughout the year.

C is required to send a Form 592-B following the end of Year X to D and E to notify each owner of withholding paid on C's behalf throughout the year and that has been allocated to D and E.

E is required to send a Form 592-B following the end of Year X to its owners to notify each owner of withholding paid on E's behalf throughout the year and that has been allocated to E's owners.

Example 4 illustrates that all lower tier pass-through entities and upper tier pass-through entities that have paid withholding or that have been allocated withholding are required to send Form 592-B to their owners that are to be allocated withholding. For lower tier pass-through entities, a Form 592-B is required to be sent to all nonresident owners because nonresident owners are the owners that have income that has been withheld upon. For upper tier pass-through entities, a Form 592-B is required to be sent to all owners because all owners, regardless of their state of residency, are allocated withholding that has been paid on their behalf by the lower tier pass-through entity and allocated to the upper tier pass-through entity.

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#### Example 5: 10-Day Notification Requirements.

Same facts as Example 2. A is required to notify C within 10 days of making each withholding payment that it remits throughout Year X. C is not required to notify its owners of the withholding A paid on its behalf throughout Year X because C is only required to allocate this withholding to its owners following the end of Year X. Similarly, E is not required to notify its owners of the withholding A paid on its behalf because E is only required to allocate this withholding to its owners following the end of Year X.

Example 5 illustrates that only the lower tier pass-through entity that has paid withholding is required to notify the nonresident owners of withholding paid within 10 days of making such payment. As a result, any upper tier pass-through entity that is only allocating withholding to its owners is not required to notify its owners of withholding paid on its behalf by the lower tier pass-through entity.

#### Example 6: Separate Withholding Requirement for Upper Tier Pass-Through Entities.

Same facts as Example 2. C also has \$20,000 of California source business income from its own operations in Year X and, as the \$20,000 is unassociated with any ownership interests in pass-through entities, there has been no prior withholding on this income. C is required to remit withholding on behalf of D's \$10,000 distributive share of C's \$20,000 of California source income by the applicable federal estimated tax due date because D is a nonresident owner. As a result, C is additionally required to notify D within 10 days of each withholding payment, send D a Form 592-B reporting the total withholding paid following the end of the year, and file Form 592-PTE with the Franchise Tax Board to report and allocate the withholding to D. C is not required to remit withholding on behalf of E's \$10,000 distributive share of C's \$20,000 of California source income by the applicable federal estimated tax due date because E is a California partnership.

Example 6 illustrates that an upper tier pass-through entity that has California source income is required to remit withholding on behalf of its nonresident owners. C becomes a lower tier pass-through entity with respect to such income and continues to be an upper tier pass-through entity for purposes of the withholding already paid on its behalf.

#### Example 7: Upper Tier S Corporation Pass-Through Entity Withholding Payment and Filing Requirements.

A is a California partnership with two equal partners, B and C. B is an individual that is a resident of California. C is a non-California S corporation. C has two equal shareholders, D and E. D is an individual that is a nonresident of California and E is an individual that is a resident of California.

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A is required to withhold tax on behalf of C at the 1.5 percent tax rate in effect under Revenue and Taxation Code section 23802 in addition to the highest marginal tax rate in effect under Revenue and Taxation Code section 17041 by the applicable federal estimated tax due date. A is not required to withhold tax on behalf of B because B was a resident of California in Year X.

A is required to file an annual Form 592-PTE following the end of Year X to report the withholding it paid on behalf of C. The filing of Form 592-PTE will allocate the withholding A paid on behalf of C to C. A is not required to file an annual Form 592-PTE following the end of Year X with respect to B because B was a resident of California and no withholding was required to be paid on his or her behalf in Year X.

C is required to file an annual Form 592-PTE following the end of Year X to report the withholding A paid on its behalf throughout Year X and that A allocated to C. The filing of Form 592-PTE will allocate the withholding A paid on C's behalf to C's owners, D and E, regardless of the owner's state of residency and in accordance with each owner's interest in C.

C cannot claim a refund for withholding paid on its income tax return. However, it can use some or all of the withholding credit to satisfy the 1.5% entity-level tax that was already withheld on its behalf by A. If C claims any of the amount withheld on its income tax return, then it must attach a copy of Form 592-B received from A and a schedule specifying the amount claimed on C's own income tax return as well as the balance allocated to the shareholders to its income tax return. Additionally, C must attach the same schedule to Form 592-PTE to allocate the balance of withholding paid on its behalf to its shareholders, D and E.

D and E are not required to file an annual Form 592-PTE following the end of Year X with respect to the withholding allocated to him or her because D and E are individuals and therefore are not required to allocate withholding. D and E can claim the withholding credit allocated to him or her on the respective individual income tax return if each attach a copy of Form 592-B received from C.

There are two differences in withholding payment and filing requirements when there is an upper tier S corporation, which this example illustrates.

First, the lower tier pass-through entity, A, must remit withholding at the 1.5 percent S corporation tax rate in effect under RTC section 23802 as well as at the highest marginal tax rate in effect under RTC section 17041. The purpose behind this is to model California's pass-through entity withholding to be consistent with California's taxation of S corporations and the S corporation's shareholders.

Second, the upper tier S corporation, C, can choose to use the withholding credit to satisfy the 1.5 percent S corporation tax that is due and has already been paid by A and allocate the rest to

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its shareholders (D and E), or it can allocate all of the withholding paid on its behalf to its shareholders (D and E). If C claims any amount withheld on its income tax return, then it must attach a copy of Form 592-B received from A, as well as a schedule specifying the amount to be claimed and amount allocated to the shareholders. This will ensure the accurate withholding credit is claimed on C's income tax return. It must also attach a schedule to Form 592-PTE specifying the amount claimed on its income tax return and the amount to be allocated to the shareholders (D and E). This will ensure the accurate withholding amount is allocated to D and E.